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Legislative Council

LC Paper No. LS21/11-12

Paper for the House Committee Meeting on 6 January 2012

Legal Service Division Report on Banking (Amendment) Bill 2011

I. SUMMARY

1.	**Objects of the Bill**	To provide for a framework for the implementation of Basel III in Hong Kong and to make related and consequential amendments.
2.	**Comments**	Basel III aims at strengthening global capital and liquidity rules with the goal of promoting a more resilient banking sector. The Bill seeks to empower the Monetary Authority (MA) to make rules to prescribe capital requirements and liquidity requirements for authorized institutions to facilitate the implementation of Basel III and approve codes of practice for provision of guidance, and make other related and consequential amendments to the Banking Ordinance (Cap. 155) such as broadening the functions of the Capital Adequacy Review Tribunal, extending the scope of duty to make disclosure to MA in respect of certain criminal proceedings and a consequential amendment to the Electronic Transactions Ordinance (Cap. 553).
3.	**Public Consultation**	The Administration informed authorized institutions of the implementation of Basel III and consulted The Hong Kong Association of Banks (HKAB) and The DTC Association (DTCA) on the major provisions of the Bill. HKAB generally supports to vest in MA rule-making powers proposed in the Bill. DTCA has not raised any comments on the Bill.
4.	**Consultation with LegCo Panel**	The Panel on Financial Affairs was briefed on 9 June 2011 on the plan to implement Basel III in Hong Kong. Members enquired about the various impact of implementing Basel III and the consequence of not implementing it.
5.	**Conclusion**	The Bill involves a change of the mechanism in which capital and liquidity requirements will be made in future. Members may consider the need for a Bills Committee.

II. REPORT

Objects of the Bill

To amend the Banking Ordinance (Cap. 155) (the Ordinance) to provide for a framework for the implementation of Basel III in Hong Kong and to make related and consequential amendments.

LegCo Brief Reference

2. B9/1/1/3C issued by the Financial Services Branch of the Financial Services and the Treasury Bureau on 8 December 2011.

Date of First Reading

3. 21 December 2011.

Comments

Background

4. The Basel Committee on Banking Supervision (BCBS) is an international standard-setting body which promotes sound standards of banking supervision globally[1]. According to the LegCo Brief, BCBS introduced banking frameworks, standards and measures commonly referred to as "Basel I", "Basel II" and "Enhancements to the Basel II framework" in 1988, 2004 and 2009 respectively, which were adopted and implemented in Hong Kong.

5. In December 2010, BCBS issued two documents, namely, "Basel III: A global regulatory framework for more resilient banks and banking systems"[2] and "Basel III: International framework for liquidity risk measurement, standards and monitoring" to strengthen global capital and liquidity rules for banks. Its objective is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real

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1 Its members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Further information on BCBS is available at http://www.bis.org/bcbs/index.htm.

2 Refinements were made to the framework by BCBS in 2011.

economy. According to the Administration, Basel III was endorsed by the leaders of the G20 at the Seoul Summit held in November 2010[3].

6. The Basel III reform package includes the introduction of three risk-weighted minimum capital ratios, improvement of the transparency of the capital base by requiring all elements of capital to be disclosed along with a detailed reconciliation to the reported accounts, creation of two buffers of capital above the regulatory minimum which banks can use during periods of stress, supplementation of the risk-based capital requirements with a leverage ratio, and the introduction of two minimum standards for funding liquidity.

Empowering the Monetary Authority (MA) to make rules for implementing Basel III

7. The Administration considers that it is important for Hong Kong, being a major international financial centre and a member of BCBS, to commit to adopting Basel III, as its implementation will ensure that the capital and liquidity frameworks for authorized institutions[4] (AIs) in Hong Kong are consistent with international standards and that AIs will not be disadvantaged vis-à-vis their peers overseas.

8. Under the current regime of Hong Kong, locally incorporated AIs are required to maintain a minimum capital adequacy ratio of 8% and all AIs should maintain a minimum liquidity ratio of 25%. The existing capital adequacy and liquidity frameworks are contained in the Ordinance and in two pieces of subsidiary legislation, namely, the Banking (Capital) Rules (Cap. 155 sub. leg. L) (B(C)R) and the Banking (Disclosure) Rules (Cap. 155 sub. leg. M) (B(D)R).

9. The Administration, in view of the complexity of the Basel III requirements and the international consensus for bank regulators to be empowered to amend regulatory standards relatively swiftly and proactively to address changing business practices and environments, proposes to remove the minimum capital and liquidity ratios from the main body of the Ordinance and use subsidiary legislation as a more flexible instrument to introduce the Basel III requirements into Hong Kong.

10. The Bill therefore does not contain any substantive provisions of Basel III. Proposed new sections 97C(1) and 97H(1) are added to empower MA to make rules to prescribe capital requirements for AIs incorporated in

[3] The G20 Finance Ministers and Central Bank Governors met in Paris in February 2011 and committed to fully implementing Basel III in line with the agreed timelines.
[4] Banks, restricted licence banks and deposit-taking companies authorized under the Ordinance.

Hong Kong and liquidity requirements for all AIs. Such rule-making powers are subject to the statutory duty imposed on MA to consult the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks (HKAB) and The DTC Association (DTCA). The rules will be subject to negative vetting by LegCo.

11. The Bill seeks to add a new part to the Ordinance to empower MA to approve codes of practice for the purpose of providing guidance in respect of any of the provisions of rules made under proposed new sections 97C(1) and 97H(1), and the current section 60A(1)[5] of the Ordinance.

<u>Broadening the functions of the Capital Adequacy Review Tribunal (the Tribunal)</u>

12. At present, an AI which is aggrieved by a specified decision of MA relating to the capital adequacy ratio calculation approaches under B(C)R may apply to the Tribunal established under the Ordinance for review. The Tribunal is currently chaired by a person qualified for appointment as a judge who sits with at least two persons not being public officers.

13. As to MA's decision to vary the capital adequacy ratio or liquidity ratio applicable to an AI, or issue a notice requiring remedial action by an AI where the AI has failed to maintain the minimum required capital/liquidity level however, the Ordinance currently provides that the AI has to appeal to the Chief Executive in Council. As the Basel III capital and liquidity requirements are more complex and technical than their predecessors, the Bill proposes to broaden the scope of the Tribunal and designate it as the forum to hear appeals against decisions by MA to vary capital or liquidity requirements, or require remedial actions by the AI when it has failed to comply with the capital or liquidity requirements.

14. The Administration also takes the view that an equivalent appeal mechanism should be made available for specified decisions of MA made under B(D)R and the proposed new rules for liquidity standards. The Bill therefore proposes to add new sections to make such MA's decisions reviewable by the Tribunal.

15. In view of the proposed extended review remit of the Tribunal, the Bill suggests to rename the Tribunal as the Banking Review Tribunal.

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[5] This provision empowers MA to make rules prescribing the information to be disclosed to the general public by AIs relating to their financial affairs.

Other related and consequential amendments

16. Section 106 of the Ordinance, which is currently set out in a part of the Ordinance that deals with liquidity ratio, imposes obligations on an AI incorporated in Hong Kong not to create certain charges and to notify MA of any civil proceedings instituted against it if those proceedings materially affect, or could materially affect, its financial position. As that section relates to matters other than liquidity ratio, the Bill proposes to relocate it to another part of the Ordinance which contains miscellaneous provisions. It further seeks to extend such disclosure duty to cover criminal proceedings as criminal proceedings can, in the Administration's view, also materially affect the AI's financial situation if they result in substantial fines and/or reputable damage.

17. In view of the above proposals, the Bill also proposes to make other necessary amendments to the Ordinance and the Electronic Transactions Ordinance (Cap. 553).

Commencement

18. The Bill, if enacted, will come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

Public Consultation

19. The Hong Kong Monetary Authority issued a circular letter on 26 January 2011 to all AIs indicating its initial thinking on the implementation of Basel III in Hong Kong. In October 2011, MA consulted HKAB and DTCA on the major provisions of the Bill. According to the Administration, HKAB is generally supportive of the approach to vest in MA enhanced rule-making powers to specify capital and liquidity requirements and has sought clarification on the underlying policy intentions of MA relating to the application of certain provisions of the Bill and the relationship of the provisions with international regulatory norms. DTCA, however, has not raised any comments on the Bill.

Consultation with LegCo Panel

20. The Administration briefed the Panel on Financial Affairs on 9 June 2011 on the plan to implement Basel III in Hong Kong. During the discussion, members enquired about the possible impact of implementing the

Basel III measures on the business development and competitiveness of Hong Kong and on AIs and their customers, in particular the small and medium sized enterprises, and the consequence of not implementing the Basel III requirements in Hong Kong.

Conclusion

21. The Bill involves a change of the mechanism in which capital and liquidity requirements will be made in future. Members may consider the need for a Bills Committee. The Legal Service Division is still scrutinizing the legal and drafting aspects of the Bill.

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